



REPORT TO THE UNIT HOLDERS IN THE ASPIRING FUND FOR THE
MONTH FEBRUARY 2017

	Aspiring Fund	NZ50G	ALL Ords Accumulation Index (rebased in NZ\$)
<u>Short-term returns</u>			
Month	1.57%	1.66%	4.82%
Last 3 Months	3.76%	3.92%	7.63%
Last 12 Months	12.96%	15.03%	19.06%

Long-term* returns and volatility

Return (annualised)	10.84%	5.66%	1.88 %
Return volatility (annualised)	8.95%	11.98%	16.60 %

* since the introduction of the PIE Tax regime, 30 Sept 2007

Unit Price: \$3.1412

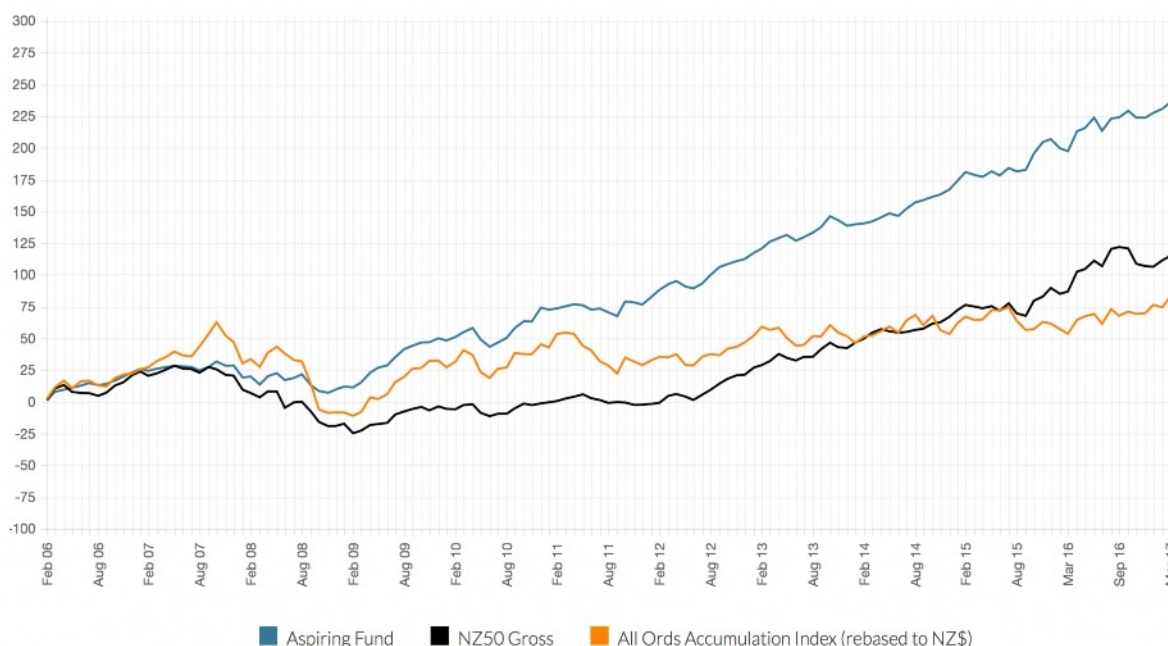
Performance after all expenses: 1.57%

Asset allocation (approximately):

New Zealand Equities	43.7%
Australian Equities	18.1%
Global Equities	7.2%
Corporate Credit/bonds	4.3%
Cash	26.8%
Short Equities	-2.2%

Net Asset Value of the Fund (approximately): \$330m

Fund Performance



The Fund returned 1.57% in February - a fair result given our cautious asset allocation and the number of landmines which we avoided during the month.

Locally, the big news was the reporting season which, unusually, brought few surprises in the results themselves although market reaction was often more difficult to understand. We suspect the 2.6% fall in the Kiwi against the A\$ helped the performance of companies with significant Australian earnings.

One candidate for this explanation is EBOS, our best performing stock (measured by contribution to the Fund's total return). The result and forward guidance were bang in line with expectations. However, the stock rose 9.5% over the month. Like many of our long term favourites this poses a conundrum. At a share price of 20x earnings, it offers value, only for those willing to pay for management's ability to continue to deliver, and particularly so relative to an expensive market.

The problem with viewing the world as expensive, is that you could have done so for most of the past few years. Our diversified portfolio and modest position sizes over this time reflects our constant awareness of risks, and as a consequence some returns have been left on the table (amongst other things we did not see the lows of bond yields driving asset valuations).

Similarly, every prudent Aucklander who has only owned their family home has missed out on one of the great investment opportunities of their lives - the house next door. With the Auckland population surging and land and new build costs constantly on the rise, what could possibly go wrong?

Well, quite a lot for some poor householders. Interest rates have bottomed and mortgage rates are rising as a result of the growth in bank lending outstripping deposit growth. The median Auckland house price now sits at about 10x median household income and 30x median rent (~3% yield). As long as incomes remain secure and funding costs remains low, that might be manageable. However, every 1% rise in interest rates means a ~5% drop in disposable income for a home owner with 50% equity, and there will be a number of home owners whose finances are so close to the Plimsoll line any unforeseen problem will put them under.

Another no-brainer investment which has also been fueled by record-low funding costs (and an extension, investors willingness to accept low returns) is Auckland Airport - a great business as reflected in a price to earnings ratio (P/E) of 33, but with earnings which are ~50% regulated. The biggest component of un-regulated earnings is derived from retail spending in its terminals. This is under increasing pressure from the maturing growth of first tier China cities, and their government efforts to capture more of that spend at home. This helped contribute to a large miss in retail revenues in the last half year and was one of a number of reasons why analysts generally found the result underwhelming. However, that did not stop the price climbing 7% after the result on a relentless wave of offshore buying.

In the 1970's there were a coterie of American stocks known as the Nifty Fifty, which you could just buy and hold forever, regardless of price, because the businesses were of such quality that their growth would always compensate for any short term over-valuation. By 1972 the S&P 500 traded on a P/E of 19 but the Nifty Fifty's average P/E was 42. Polaroid's growth prospects were so stellar it warranted a P/E of 91. The first oil shock, consequent inflation and the end of Bretton Woods caused a 45% decline in the US market in 1973-74 with the Nifty Fifty the biggest casualties - Polaroid fell 91% from its highs and falls of 80%+ were commonplace.

More recently, we have seen a similar story with the dotcom bubble of the late 90's but the critical difference was that the Nifty Fifty had earnings, products and services in keen demand, proven business models and management. Not even all of these qualities made up for extreme over-valuation.

We are not suggesting a repeat of this is likely or imminent for either Auckland house prices or the Auckland Airport share price, but earnings yields of 3% are simply too low for us.

We know that trends in place will always run further and longer than most market participants think possible. However, they do not last for ever and the catalyst for the directional change is invariably only obvious with hindsight - or extreme good fortune.

Reverting to the February reporting season. Unusually there were few surprises, with the level of underlying growth broadly at broker expectations, and only modest downward revisions to future earnings.

In New Zealand, Forsyth Barr analysis showed revenue and operating earnings were up only 2% on the prior year. In our view, this is nothing to celebrate given the strong macro tailwinds experienced including population growth, tourism, and house price inflation.

One of the clear themes was the poor showing of domestic building cyclicals. We are increasingly seeing evidence across our industry contacts of the emergence of 'peak cycle problems', and this was apparent in Fletcher Building's share price fall of 8% for the month, while Metro Performance Glass was down 23%. Earnings leverage to the up-swing in volumes has disappointed, in part impacted by a benign inflationary environment, and competitive pressures from an already high return base.

Broker expectations of Fletcher Building's 12-month forward earnings are only 15% higher today than they were in March 2010. The difference can be largely explained by the company's now 'in-the-money' land bank. Following a disappointing interim result, Metro Glass are now guiding to FY17 profit of c\$19-20.5m. On a like for like basis, after excluding an acquisition, this is about 60% of the \$33m expected at the time of the IPO in late 2014. We note that the share price is only 11% lower than the \$1.70 set in the IPO.

High future earnings implicit in company valuations has made investment in this space very challenging for us. We are too shy to call the peak in the cycle clock – but we are confident that it is late in the night rather than early in the afternoon. We are likely to be treading very carefully unless expectations and/or share prices adjust.

The other notable piece of corporate news was the Commerce Commission's decision to reject the proposed merger of Sky TV and Vodafone NZ. Sky was a Top-3 position for the Fund in the middle of 2016 when our thesis anticipated merger success and an implicit good entry into a majority telco combined business. Fortunately, when risk to our thesis started to evolve we were able to exit at an average price of around \$4.80. Sky TV shares traded down to an 8-year low of \$3.60 in February and finished down 18% for the month.

We remain perplexed by the Commission's verdict – but have taken a key observation that the regulator may not look as far out as many investors do. Somewhat surprisingly, Sky has only seen a 3% fall in subscription revenue over the past two years, but the concern from here is its ability to hold on to this revenue without the in-house technology expertise the merger with Vodafone would have provided.

Having largely avoided a number of potential land mines, we were pleased with the results and share price reactions of a few of our larger investments.

We have already mentioned EBOS but we were pleased to see our biggest positions in the gentailers, Contact (4.8%) and Meridian (2.7%), being the best performers in the sector. Their respective results were close to analyst forecasts, as you can expect with the sector.

Among our other holdings, CBL, a specialist insurer, fell 21% after posting a result which was universally regarded as disappointing. This company is a relatively recent listing with highly incentivised management who own about 35% of the company. We suspect a large part of this fall can be attributed to the market and company struggling to understand each other, as management subsequently issued a statement clarifying the result and the price has recovered over half of this fall. We had reduced our position prior to this clarification. The company has been a stunning performer as we paid \$1.55 in the IPO 15 months ago and it reached a low of \$2.98 in the sell-off (is \$3.34 at the time of writing).

Sanford was up strongly (+6.5%) in the month despite the absence of any corporate news. The company has a new management team with a strategy which could be transformational for the company. Liquidity and institutional interest have both improved markedly in recent months, driving speculation of NZ50 index inclusion. Sanford has been one of our best performers and through price appreciation and participation in some block trades, the position has risen in our top 10 holdings. We could not resist banking some profits late in the month.

One of the most pleasing aspects of the latest round in reporting, was the predictability of a lot of results among our core mid and small caps, and their stable share price reactions. Companies like Vista, Tourism Holdings, Heartland Bank, Airwork, Scales and NZ King Salmon all held steady through the reporting season.

Our Aussie portfolio performed well and largely in line with the broader market. The Fund received the added benefit of a naked currency position with the 2.6% fall in the Kiwi against the A\$.

Reporting season is always a white knuckle ride in Aussie given the market's ruthlessness when assessing earnings announcements and a number of market darlings on stellar P/E's suffered big price falls. Our aversion to high P/E's meant we avoided these land mines - and the preceding gains.

ANZ and Super Retail were the biggest contributors to Fund performance. Banks in general are benefitting from cost-out, combined with improved margins on mortgage repricing, and a gradually improving economy as commodity prices lift. Super Retail was one of a bunch of strong performing retail stocks in Australia. The stock ended the month up 8% and reached a point where our risk/reward threshold was met, and we have now exited the position.

Our international portfolio had a great month. The Trump trade is buoying US and global markets and the growth orientation of our small international portfolio benefitted from this. As we hold these positions unhedged, the Fund also benefitted from the 1.6% fall in the Kiwi over the month.

The fund remains well diversified within and across equity markets. NZ equities remain our main exposure at about 43% of the Fund, but our portfolio is far more diversified than the underlying market with our top 3 holdings comprising only 10% of the Fund. We are encouraged by a couple of prospective new issues and we remain confident that patience will be rewarded with sensibly priced new opportunities over time.

TOP 10 HOLDINGS AS AT THE 28th FEBRUARY 2017

Contact	3.7%
Spark	3.3%
EBOS	3.1%
Sanford	2.8%
Google	2.6%
Heartland	2.5%
Meridian	2.2%
Mainfreight	1.9%
Fisher & Paykel Healthcare	1.8%
Green Cross Health	1.6%

Aspiring Asset Management Limited

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